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C O N F I D E N T I A L SECTION 01 OF 04 BEIJING 000623

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TAGS: ECON ENRG EPET EINV EFIN CH RS
SUBJECT: CHINA/RUSSIA: LOANS-FOR-OIL DEAL STILL IN THE PIPELINE

Reftel: A. Moscow 528, B. Beijing 00592

Classified by Economic Minister Counselor Robert S. Luke for reasons 1.4 b/d.

SUMMARY

¶1. (C) After months of negotiations, China and Russia appear closer to reaching an agreement on the expansion of the East Siberia-Pacific Ocean (ESPO) Pipeline to northeast China. A USD 25 billion oil-for-loans agreement announced in mid-February will, if finalized, provide much-needed liquidity to debt-ridden Russian pipeline and oil companies, while also reducing ChinaQs reliance on imports from the Middle East and further extending Chinas energy security at a time when domestic oil supplies are nearing maximum production. Embassy contacts report that the deal is commercially-driven and that terms of the agreement will be market-based, but key details about the deal are elusive. Issues that have reportedly plagued previous attempts to reach an agreement including oil pricing mechanisms, loan interest rates, and repayment arrangements remain under negotiation, and embassy contacts, including one member of the Chinese negotiating team, predict that the final approval process could be slow. END SUMMARY

China, Russia announce USD 25 billion loans-for-oil agreement
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¶2. (C) After months of negotiations, China and Russia appear closer to reaching a detailed agreement on the expansion of the East Siberia-Pacific Ocean (ESPO) Pipeline to northeast China (ref A). Chinese Vice-Premier Wang Qishan and Russian Deputy Prime Minister Igor Sechin reached a preliminary intergovernmental USD 25 billion loans-for-oil agreement in Beijing on February 17. China National Energy Administration Department of Oil and Natural Gas Director Dr. Yang Lei confirmed that commercial agreements have also been signed by the parties involved, but added that the terms of agreement remain either confidential or still under negotiation.

¶3. (SBU) According to media reporting, Russian state-owned oil company Rosneft and oil transport company Transneft have each signed long-term agreements

with China National Petroleum Corporation (CNPC) and China Development Bank (CDB), a Chinese policy bank in the process of becoming a commercial financial institution. The Export-Import Bank of China (Exim Bank) will reportedly also contribute to the loan package. Under the agreements, CDB will loan USD 10 billion to Transneft and USD 15 billion to Rosneft, collateralized by an agreement to supply approximately 15 million metric tons of crude per year over twenty years (the equivalent of 300,000 barrels/day) to CNPC via pipeline. Transneft will construct a 67 km pipeline spur linking the East Siberia-Pacific Ocean (ESPO) Pipeline from Skovorodino to Mohe terminal in ChinaQs northern Heilongjiang Province, while CNPC will construct a 960 km pipeline to transport the oil from Mohe to Daqing, ChinaQs largest oil field, where it will connect with the broader Chinese pipeline system.

Go Out policy bolstered by economic crisis

¶4. (C) The oil-for-loans agreement reached with Russia is one of several recent high profile international energy and minerals deals financed by CDB in support of Chinas Go Out (zouchuqu) policy, which encourages capable firms to invest abroad to promote ChinaQs economic development. Initial formulations of the policy focused on investment overseas to secure brands, distribution channels, management expertise, and technology. The latest wave of Chinese outbound investment is overwhelmingly focused on the natural

resources sector, although the local Chinese press has been full of commentary, some contradictory, by various government and private sector officials about the sectors in which China should encourage overseas investment.

¶5. (SBU) Beijing-based economist Arthur Kroeber concluded in a recent report that Beijing seems to have decided that the time is ripe to move aggressively to lock in resource assets. Loans collateralized by guaranteed oil deliveries appear to be Chinas new tactic of choice, the report stated. According to Caijing Magazine, a well-regarded Chinese economic journal, CDB is now working as the primary lender for some USD 60 billion in credit packages. Two other major deals in progress involving CDB and Chinese state-owned oil companies include a USD 10 billion loan to Brazils Petrobras for a guarantee of 100-160,000 barrels/day, and a USD 4 billion loan to Venezuelas PDVSA in exchange for a supply of 80,000-200,000 barrels/day. CDB is also reportedly involved in financing the state-owned Aluminum Corporation of Chinas (Chinalco) controversial bid for a stake in Anglo-Australian mining giant Rio Tinto (Ref B).

¶6. (C) Zhang Guobao, Head of Chinas National Energy Administration (NEA) and Vice-Chairman of the National Development and Reform Commission (NDRC) announced in February that Qthe (economic) slowdown has reduced the price of international energy resources and assets, and favors our search for overseas resources.Q Although the broader Chinese economy has been hard hit by the crisis, Chinas major state-owned commercial and policy banks have had less exposure to global financial markets and remain well-positioned to finance ChinaQs leading state-owned enterprises (SOEs) overseas projects and investments. Arthur Yan, of Cambridge Energy Research Associates (CERA) Beijing office told Econoff that most of the recently announced deals would not be possible without Chinese policy banks and high-level support from the Chinese government, including the State Council and the NDRC.

QDeal benefits China, Russia; boosts global energy securityQ

¶7. (C) CNPC International Department Director-General Zhang Xin called the deal a Qwin-win agreement, noting that it would serve both countries economic interests, including by supporting Russias market diversification goals, and added that it would also enhance global energy security by bringing more oil to the market. CERAs Yan and Dr. Zhao Hongtu, Research Professor at the Institute of World Economic Studies at the China Institutes of Contemporary International Relations (CICIR), told Econoff in separate meetings that the deal would also strengthen ChinaQs energy security by reducing its reliance on oil imported by tanker through the Strait of Malacca from the Middle East. (Comment: Imports satisfy about 50 percent of Chinas oil consumption, a figure that is expected to rise as domestic fields reach peak production. Beijing belives tanker shipments could be threatened in the event of a crisis in the Taiwan Strait or the Middle East, and oil channeled by pipeline from Russia could therefore play an important energy security role. End Comment.)

¶8. (C) Zhao also noted that recent long-term oil supply deals will also reassure Chinese energy planners concerned about the impact of market volatility on oil supplies. Chinese energy policy makers don't trust the market. They hold a lot of conspiracy theories,Q he explained. (Comment: A long-term supply contract does not necessarily constitute a supply guarantee and it appears that the current deal is simply an agreement to make oil available to sell to CNPC. That said, given the alternative of shipping oil at a high cost from the Russian Far East to other markets,

Russia would have a significant incentive to increase oil exports to China once production is at full capacity and the pipeline is fully operational. End Comment.)

Chinese approval shouldn't be a problem, but Russia may need more time
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¶9. (C) CNPC DG Zhang and Russian Embassy Economic Counselor Sergey Yakimets informed Econoff separately that commercial details would be worked out in the coming month and that the agreements should be concluded by the end of March. Other Embassy contacts, however, predict that more time will be needed. NEAs Yang told econoff that although an agreement had been signed between Wang and Sechin, it was not finalized and would still require formal approval by both governments. Yang predicted that Chinas approval would not be a problem but that Russia would likely need more time to officially approve the deal,Q suggesting that Russian negotiators may not yet be satisfied with Chinas proposed terms and that negotiations on loan interest rates, repayment, and oil pricing formulas could be protracted. CERAs Yan, an advisor to CNPC and other Chinese state-owned oil companies, also predicted that deal negotiations would be unlikely to move forward quickly.

China not dependent on Russian oil

¶10. (C) CICIRQs Zhao underscored that China by no means views itself as dependent on Russia for oil. QInternational oil markets are better integrated than in the past, so China can source its oil from anywhere in the world. China would not agree to a deal with Russia unless there were clear benefits, he stated. NEAs Yang, who participated in the deal negotiations, also stressed that China does not need to acquire

Russian oil in the near-term since oil is available in other markets. Yang observed that during the latest round of negotiations, the Russian delegation portrayed themselves as doing China a favor by supplying it with oil. From Chinas perspective, Russia is not doing anyone a favor...Its a commercial deal and China will pay the Russian companies a fair price, Yang asserted.

Commercial Details remain elusive

¶11. (C) CNPC and NEA contacts report that details involving oil pricing, loan disbursement, and loan interest rates are either confidential or remain under negotiation. Dr. Zha Daojiong, Director of People's University's Center for International Energy Security and an advisor to the Chinese Government on energy security issues, told Econoff that, given all of the unknowns at this point, it is still too early to tell whom the deal would benefit in the long and short-term or whether the deal will ultimately move forward at all. Zha noted that there have been many cases in which energy supply deals with Russia have been hindered due to the inability to reach agreement on details such as pricing. I hope the Chinese government has thought this through very carefully, he said. Russian Embassy economic counselor Sergey Yakimets also acknowledged that disagreements on pricing and interest rates had hindered previous deals and noted that ongoing commercial negotiations would have to carefully address such issues.

Interest rate, loan disbursement mechanism, and repayment details still murky
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¶12. (C) Caijing Magazine reported March 9 that the two sides had agreed to adopt a partially floating interest rate pegged to the Libor rate using a special pricing mechanism to hedge against extreme fluctuations. According to Caijings sources, the rate is expected to float between 6 and 7 percent. NEAQs Yang declined to

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